# INDEX



## CITATIONS

Cases:



Statutes:



Miscellaneous:

# In the Supreme Court of the United States

OCTOBER TERM, 1948

---

No. 108

GRAHAM FLYING SERVICE, A CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

---

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

---

## BRIEF FOR THE RESPONDENT IN OPPOSITION

---

### OPINIONS BELOW

The opinion of the Tax Court (R. 7-16) is reported in 8 T.C. 557. The opinion of the Circuit Court of Appeals (R. 31-37) is reported in 167 F. 2d 91.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 25, 1948. (R. 37-38.) The petition for a writ of certiorari was filed on June 21, 1948. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether the courts below correctly held that the taxpayer was a corporation in which capital was a material income-producing factor and therefore ineligible for exemption from excess profits taxes as a personal service corporation under Section 725(a) of the Internal Revenue Code.

### STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra,* pp. 11-16.

### STATEMENT

The facts as stipulated (R. 23-25) and as found by the Tax Court (R. 8-13) are as follows:

During 1941 and 1942 taxpayer was a corporation conducting a flying school near Sioux City, Iowa. E. L. Graham owned ninety-six percent of its capital stock and he was president and general manager. He devoted his entire time to taxpayer's business and conducted its affairs in any manner he saw fit. Graham's wife and brother each owned two percent of taxpayer's stock. They were secretary and vice-president, respectively, but neither they, nor any of taxpayer's employees, had anything to do with the management of the business. (R. 8-9.)

Graham had considerable experience in flying and maintaining aircraft and was licensed as a commercial pilot. In 1939 he operated a flying school for profit in conjunction with Morningside College, under a contract with the Civil Aeronautics Administration, hereinafter sometimes referred to as C. A. A. The college conducted the

ground school phase of the instruction, and Graham taught some of these classes without compensation. Taxpayer was incorporated in 1940, and thereafter operated the flying school. (R. 9.)

Taxpayer's capital stock was $8,453, which was issued in exchange for personal property furnished by Graham (R. 24), including five planes (R. 11).

Under the terms of various contracts with C. A. A., taxpayer was required to provide a certain ratio of licensed instructors and approved aircraft to students assigned by the college, and to furnish dual, check, and solo instruction in accordance with prescribed flight curricula and specified schedules of flying time. Taxpayer provided instruction for between three hundred and four hundred students during 1941 and 1942, consisting principally of a primary and a secondary course. The secondary course required a heavier plane. Taxpayer received specified sums for each student who completed the respective courses. Also, it offered courses for training flight instructors, and commercial and cross-country pilots. Hourly rates were charged for uncompleted courses. (R. 9-10.)

Graham was taxpayer's chief instructor and only flight examiner. He also held a certificate for aircraft maintenance. In 1941 he taught one complete class of apprentice instructors and also one complete class of secondary students. He knew practically all the students personally. In 1941 and 1942 Graham gave spot checks, flight checks, and final flight tests to many students. He per-

sonally flew with and either examined or instructed ninety percent of taxpayer's students. The remaining tests were given by representatives of C. A. A. Graham worked from daylight to dark, usually seven days a week. He devoted about seventy percent of his time to instruction, including checks and tests, about twenty percent to supervision of other instructors, and about ten percent to management duties. In 1941 he was assisted by five instructors, three mechanics and two office employees, who earned $24,537.14. In 1942 there were eleven instructors, four mechanics, three office employees, and three guards, who earned $45,064.33. Graham's salary was $3,600 in 1941 and $9,600 in 1942. (R. 10.)

During 1941 taxpayer operated from a leased airfield, but early in 1942 it purchased a field for approximately $21,000, making an initial payment of $3,000 from accumulated earnings. It spent $8,000, about half of which it borrowed, for construction of an administration building, office, repair shops, and hangars. (R. 10.) Also, it purchased airplanes, parachutes, and repair parts for training purposes. At the end of 1941 taxpayer owned thirteen airplanes which had cost $34,960.42, and at the end of 1942 it owned twenty-six airplanes which had cost $77,707.80. Most of the planes were purchased by making a down payment of ten percent from earnings and borrowing the balance of the purchase price from the Reconstruction Finance Corporation, the aircraft and the C. A. A. contracts being used as security. For a

short period in 1941 two airplanes were rented. (R. 11.)

Fuel and oil used in taxpayer's smaller planes cost from $1 to $1.20 per hour. The cost of gasoline alone for the larger planes was from $10.50 to $11 per hour. Taxpayer charged $8 per hour for the smaller planes and $15 to $18 per hour for the larger planes when they were rented on occasion to pilots, which charges included fuel and oil. The cost of plane operation and maintenance was $16,806.63 for 1941 and $23,192.12 for 1942. (R. 11.)

Taxpayer's average borrowed capital was $8,742.62 in 1941 and $34,399.34 in 1942. The entire capital for the two taxable years was used to purchase facilities and equipment to conduct the flying school. (R. 11.)

Taxpayer's balance sheets as of the end of 1941 and 1942 were as follows (R. 11-12):

Assets:

| | *Dec. 31, 1941* | *Dec. 31, 1942* |
|---|---|---|
| Cash | $7,363.38 | $1,191.46 |
| Notes and accounts receivable | 11,958.78 | 48,898.05 |
| Inventories | 384.34 | 844.83 |
| Deposit on airplane | 125.00 | 390.00 |
| Furniture, equipment (including airplanes and parachutes) less depreciation | 34,689.50 | 97,910.82 |
| Prepaid expenses | 2,590.77 | 6,459.35 |
| Total assets | 57,111.77 | 155,694.51 |

| Liabilities: | | |
|---|---|---|
| Accounts payable | $2,366.77 | $14,028.06 |
| Bonds, notes, and mortgages payable | 17,478.70 | 77,798.73 |
| Accrued taxes | 6,249.06 | 18,184.50 |
| Other liabilities | 1,362.37 | |
| Surplus reserves | 2,427.35 | 2,427.35 |
| Capital stock | 8,453.00 | 8,453.00 |
| Earned surplus and undivided profits | 18,774.52 | 34,802.87 |
| Total liabilities | 57,111.77 | 155,694.51 |

The compensation received by taxpayer from all sources for flight instruction was $75,729.17 for 1941 and $137,504.96 for 1942. In addition, taxpayer derived income of $4,176.63 in 1941 and $2,711.73 in 1942 from charter flights, the storage and repair of planes not owned by it, and miscellaneous sales and services. Its net income was $22,530.19 for 1941 and $24,880.08 for 1942. (R. 12.)

In its original 1941 income tax return taxpayer failed to elect to be exempt from excess profits tax as a personal service corporation, and it filed an excess profits tax return. An amended 1941 income tax return was filed on or about March 15, 1944, to which was attached a personal service corporation return of income (undistributed Supplement S net income). An amended excess profits tax return was filed on or after May 29, 1944, in which it was stated that taxpayer was not subject to excess profits tax. (R. 12-13.)

The Commissioner determined that taxpayer was not a personal service corporation for 1941 and 1942. The Tax Court sustained the Commissioner. It held that taxpayer's capital was a material income-producing factor during both years, and that it was not necessary to determine whether the other

provisions of the statute had been met. (R. 16.) The Circuit Court of Appeals affirmed. (R. 37.)

ARGUMENT

The Tax Court and the court below held, correctly we submit, that the taxpayer was not, within the meaning of Section 725(a) of the Internal Revenue Code (Appendix, *infra,* pp. 11-12), a "personal service corporation" since capital invested in the corporation was a "material income-producing factor."

The Tax Court found that the entire capital of the corporation for the two taxable years was employed to purchase facilities and equipment such as planes, parachutes, repair parts, an administration building and an airfield in order to conduct a flying school. At the end of 1941 the corporation owned thirteen airplanes, which had cost nearly $35,000, and at the end of 1942 it owned twenty-six airplanes, which had cost $77,000, and an airfield purchased for $21,000. (R. 10-11.) On December 31, 1941, the taxpayer's assets were valued at about $57,000 and on December 31, 1942, at about $155,000. The income received for flight instruction during 1941 was $75,000 and for 1942, $137,000. (R. 12.) This instruction was given in accordance with contracts with the Civil Aeronautics Administration which required that the taxpayer provide a certain ratio of approved aircraft to students, maintain its equipment and facilities in accordance with prescribed standards and furnish flight instruction in accordance with prescribed flight curricula and within specified schedules of

flying time. (R. 9.) Two courses were given, the second of which, involving the use of heavier planes and requiring about twenty-five per cent more flying hours, cost more than twice as much as the primary course. (R. 9-10.) Both courts below concluded that without the airfield and the aircraft and other facilities taxpayer could not have produced the corporate income and that the use of the capital invested in such equipment could not be considered as being merely incidental to the conduct of the taxpayer's business.[1]

This conclusion is clearly correct. The capital invested in the airplanes and in the airport cannot be considered in the same light as capital utilized in the form of office rent, wages, supplies and incidental expenses.[2] The equipment here was not like an office; rather it was the very thing whose use was required to be made available to students and for which petitioner was paid the income here taxed. Cf. *William A. Brady Theatre Co.* v. *Commissioner*, 42 F. 2d 181, 183 (C.C.A. 2). No reasonable conclusion would seem to be possible other

---

[1] This conclusion being sufficient to support the Commissioner's determination it became unnecessary to consider two other contentions which the Commissioner urged, as follows: (1) the income was not primarily ascribable to the activities of the shareholder owning more than 70 per cent of the corporate stock; (2) the taxpayer did not make the timely election required by Section 725(b), Internal Revenue Code, to be classified as a personal service corporation for 1941.

[2] *Edward P. Allison Co.* v. *Commissioner*, 63 F. 2d 553 (C.C.A. 8); *Dreyer Commission Co.* v. *Hellmich*, 25 F. 2d 408 (C.C.A. 8); *F. Wallis Armstrong Co.* v. *McCaughn*, 21 F. 2d 636 (E.D. Pa.). These cases were all decided under earlier statutes which, however, do not differ in any material respect from Section 725(a) of the Internal Revenue Code.

than that the income was attributable in large measure to the use of airplanes and other equipment in which substantial capital was invested.

The taxpayer's contention (Pet. 7-10) that the decision below is in conflict with *Shipley School* v. *McCaughn*, 34 F. 2d 281 (C.C.A. 3), and *Strayer's Business College* v. *Commissioner*, 35 F. 2d 426 (C.C.A. 4), misconstrues the nature of the problem under consideration. The question in this case is one of degree since the statute requires that capital be not a *material* income-producing factor. The determination of such a question is basically for the trier of the facts and each case must necessarily depend upon the particular facts shown. The two cited cases turned on the application of similar statutory provisions,[3] but dealt with schools in no way comparable to the kind operated by this taxpayer. In the *Shipley* case, the capital invested was in furniture and equipment not in excess of $25,000, and the income of the school was found to be derived essentially from the relationship of the two owners of the school to their pupils based on their personal attention, teaching and exclusive oversight. In the *Strayer* case, the capital amounted to but $5,000 and was used chiefly for the purchase of furniture and equipment. The capital thus employed was deemed but nominal and incidental to the operation of the business.

The factual differences between those cases and the present case are obvious. The alleged con-

---

[3] Revenue Act of 1921, c. 136, 42 Stat. 227, Sec. 200; Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 200.

flict would exist only if the statute were construed so as to include every type of school regardless of the nature of the school equipment and the amount of capital invested therein. No case decided by any of the courts would support such a conclusion. The basic test is "the way in which capital makes its contribution" to income (*Edward P. Allison Co.* v. *Commissioner,* 63 F. 2d 553, 558 (C.C.A. 8)) and this must be determined on the facts of each case.

## CONCLUSION

The decision of the court below is correct, there is no conflict of decisions, and the case does not warrant further review. The petition should, therefore, be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
*Solicitor General.*
THERON LAMAR CAUDLE,
*Assistant Attorney General.*
GEORGE A. STINSON,
ABBOTT M. SELLERS,
S. WALTER SHINE,
*Special Assistants to the Attorney General.*

JULY, 1948.

APPENDIX

Internal Revenue Code:

SEC. 394 (as added by Sec. 502, Second Revenue Act of 1940, c. 757, 54 Stat. 974). CORPORATION INCOME TAXED TO SHAREHOLDERS.

(a) *General Rule.*—The undistributed Supplement S net income of a personal service corporation shall be included in the gross income of the shareholders in the manner and to the extent set forth in this Supplement.

(b) *Amount Included in Gross Income.*—Each shareholder who, on the last day of the taxable year of the corporation, was a shareholder in such corporation shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend if on such last day there had been distributed by the corporation, and received by the shareholders, an amount equal to the undistributed Supplement S net income of the corporation for its taxable year.

* * * * *

(26 U. S. C. 1940 ed., Sec. 394.)

SEC. 725 (As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974). PERSONAL SERVICE CORPORATIONS.

(a) *Definition.*—As used in this subchapter, the term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of shareholders who are regularly engaged in the active conduct of the affairs of the corporation

and are the owners at all times during the taxable year of at least 70 per centum in value of each class of stock of the corporation, and in which capital is not a material income-producing factor; * * *

(b) *Election as to Taxability.*—If a personal service corporation signifies, in its return under Chapter 1 for any taxable year, its desire not to be subject to the tax imposed under this subchapter for such taxable year, it shall be exempt from such tax for such year, and the provisions of Supplement S of Chapter 1 shall apply to the shareholders in such corporation who were such shareholders on the last day of such taxable year of the corporation. * * *

(26 U. S. C. 1940 ed., Sec. 725.)

Treasury Regulations 109, promulgated under the Internal Revenue Code:

Sec. 30.725–2 (As added by T. D. 5036, 1941–1 Cum. Bull. 276). *Definition of personal service corporation.*— * * *

* * * * *

(c) *Income to be ascribed primarily to the activities of shareholders.*—If employees other than shareholders contribute substantially to the services rendered by a corporation, such corporation is not a personal service corporation unless, in every case in which services are so rendered, the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the

shareholders and such fact is evidenced in some definite manner in the normal course of the business or profession. The fact that the shareholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business or profession, the shareholders of which are not regularly engaged in the activities of the corporation, does not of itself constitute the corporation a personal service corporation.

* * * * *

It may happen that a corporation is engaged in two or more businesses or professions which are more or less related. Thus, an engineering concern may also engage in contracting, which amounts to trading in materials and labor, or a brokerage concern may guarantee some of its accounts, or a photographic concern may sell pictures, frames, art goods, and supplies. In such cases, the corporation is not a personal service corporation unless the activities of the corporation consisting of trading or guaranteeing of accounts or selling are negligible or merely incidental, and unless no appreciable part of the earnings is to be ascribed to such activities. See also (e) below relating to the employment of capital.

* * * * *

(e) *Capital as a material income-producing factor.*—In a personal service corporation capital must not be a material income-producing factor. Whether capital is a material in-

come-producing factor is to be determined by reference to (a) the extent to which capital is required to carry on the business or profession, and (b) the extent to which capital is actually used in the production of income though not required by the primary activities of the corporation. If the use of capital is necessary to the production of the income of the corporation and is more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. If a substantial portion of the income is attributable to a use of capital, whether or not connected with the primary activities of the corporation, capital is a material income-producing factor even though such use of capital is not necessary to such primary activities. The term "capital" as used in section 725 and in this section means not only capital actually invested by the shareholders but also capital obtained in other ways. Thus, capital may be borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable, or other paper, or indirectly as shown by accounts payable or other forms of credit, or the business of the corporation may be financed in some other manner by its shareholders. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or for other reasons such use of capital is necessary and more than incidental in order to secure or hold business which would otherwise be lost. If a corporation engaged in an agency, brokerage, or commission business regularly employs a sub-

stantial amount of capital to lend to its principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, such corporation is not a personal service corporation. In general, the larger the amount of capital actually used the stronger is the evidence that capital is necessary and more than incidental and is a material income-producing factor.

The term "income" as used in section 725 and in this section means gross income. Capital is a material income-producing factor if its use results in a substantial amount of gross income, irrespective of the amount of net income, if any, such use produces.

(f) *Application of regulations; returns.*— No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's income tax return whether it is or is not a personal service corporation. In the preceding subsections are set forth the general principles under which such determination will be made.

If a corporation claiming to be a personal service corporation signifies in its return under Chapter 1 for any taxable year its desire not to be subject to the excess profits tax under Subchapter E of Chapter 2 for such taxable year, it shall attach Form 1121PS, in duplicate, to its income tax return on Form 1120. In Form 1121PS there shall be stated (a) such facts as tend to show whether or not the corporation is a personal service corporation, in-

cluding (1) the nature of its business, (2) the character, preferences, dividend rates, and other essential features of the various classes of its stock outstanding for any time during the taxable year, (3) the names and addresses of its several shareholders and their relationship to each other, (4) the number and classes of shares owned at any time during the taxable year by each shareholder and the portion of the year during which such shares were so owned, (5) the nature of the activities of the several shareholders on behalf of the corporation, and (6) the extent to which capital in any form is used in the business, and (b) the computation of the undistributed Supplement S net income for the taxable year, the names and addresses of all shareholders of the corporation at the close of the taxable year, the number and classes of shares held by each, and such other information as may be required by the form and the instructions printed on the form or issued therewith.

Sec. 30.725–3 (As added by T. D. 5036, 1941–1 Cum. Bull. 276). *Election as to taxability.*— * * * A new election is required for each taxable year. An amended return filed after the statutory period for filing the return (or after the last day of any extension period) is not a return within the meaning of section 725 (b).

* * * * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1948 799173 11